Economic Update

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Sustained Real Growth Raises Revenue, Helps Trim Deficit

Incoming data and evidence continue to show a sustained expansion in the U.S. economy, with solid real economic growth, increasing payroll jobs, and relatively low unemployment, inflation, and interest rates. Personal and corporate incomes are showing stronger increases, and along with those gains, Federal tax receipts are increasing sharply, pushing down the budget deficit for the current fiscal year.

International financial markets reacted to the shock of London's terrorist bombings, but did not falter significantly. European stock markets initially declined on the day of the attacks, but ultimately not by significant amounts. U.S. markets were only slightly affected.

Recent Data

Late last month, the Bureau of Economic Analysis released "final" estimates for gross domestic product [GDP] in the first quarter of this year, showing that real GDP growth was revised up to 3.8 percent at an annual rate from the prior, preliminary estimate of 3.5 percent. The report was further evidence of continued solid growth – now totaling 14 consecutive quarters of growth following the recession, and eight consecutive quarters of growth above 3¼ percent.

The GDP report was even better, however, than suggested solely by the 3.8-percent rate and the upward revision. The report also noted positive revisions in the following:

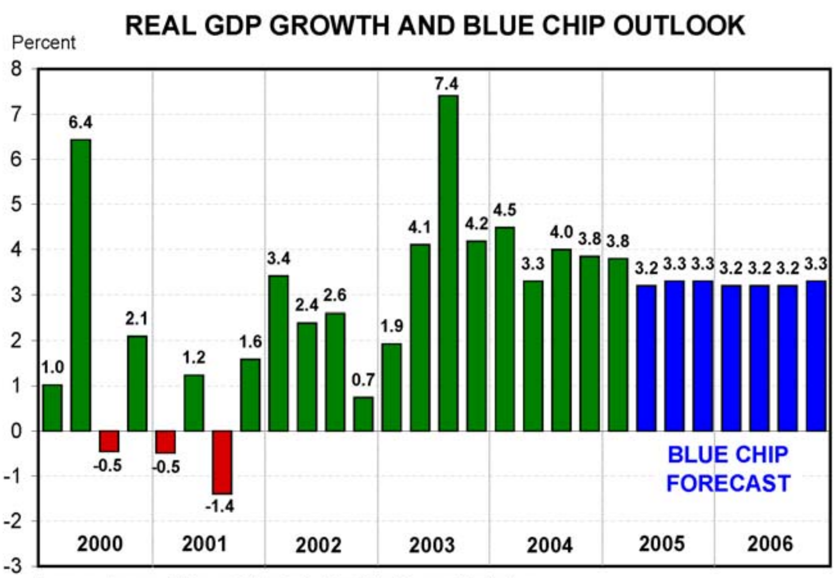
- *Income measures*: Corporate profits before tax – a key measure of taxable profits – were revised up by $16 billion (at an annual rate) for the first quarter. Compensation of employees was revised up by $10 billion (although the increase largely was for nontaxable health and pension supplements). Both these revisions were greater than the upward revision to GDP.

- *Taxes paid*: Corporate income taxes were revised up by $17 billion (at an annual rate) for the first quarter, and personal income taxes by $15 billion.

- *Inflation*: GDP price index inflation for the first quarter was revised down from 3.2 percent at an annual rate to 2.9 percent; inflation for personal consumption expenditures [PCE] excluding food and energy items was revised down from 2.2 percent to 2.0 percent.

Other data confirm the view for ongoing solid growth:

- *Employment*: The unemployment rate fell to 5.0 percent in June – the lowest rate since September 2001, and a



Sources: Bureau of Economic Analysis; Blue Chip Economic Indicators

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lower rate than the decade averages for the 1970s, 1980s, and 1990s. Payroll employment increased by 146,000 jobs in June – and estimated jobs gains in April and May were revised up by 44,000 jobs. Payroll employment has now increased for 25 straight months and by a total of more than 3.7 million jobs.

Blue Chip Economic Outlook, July 2005

	2004.4	2005.1	2005.2	2005.3	2005.4	2006.1	2006.2	2006.3	2006.4
	----- *Actual* -----		*Projection*						
Real GDP Growth	3.8	3.8	3.2	3.3	3.3	3.2	3.2	3.2	3.3
Unemployment Rate	5.4	5.3	5.1	5.1	5.1	5.1	5.1	5.0	5.1
CPI Inflation	3.4	2.5	4.2	2.4	2.4	2.4	2.5	2.3	2.3
3-month Treasury Bill	2.0	2.5	2.9	3.4	3.7	3.9	4.0	4.0	4.1
10-year Treasury Note	4.2	4.3	4.2	4.3	4.5	4.7	4.8	4.9	4.9

Note: Unemployment and interest rate values for 2005.2 are actual values.

- *Housing*: Housing starts in recent months have maintained a pace of around 2 million units at an annual rate – continuing to run at the highest sustained levels in 25 years. Sales of both new and existing single-family houses – and home ownership rates – have been running at record high levels. Household net worth is up 10.7 percent over the past year, boosted by a 14.9-percent increase in household real estate values.

- *Other indicators*: Other positive indicators include the Institute for Supply Management's [ISM's] indexes of manufacturing and non-manufacturing business activity, consumer sentiment and confidence, and industrial production.

The price of crude oil – which recently pushed up to record highs of more than $60 per barrel – remains a concern. In early July, the national average retail price of gasoline rose to $2.33 per gallon, up from $1.92 a year earlier. The higher prices likely are acting as a partial drag on the economy: the Blue Chip forecasters say it will subtract about 0.5 percentage point from real GDP growth in 2005. Thus far, however, the economy has been strong enough to weather the increases.

Blue Chip Outlook

The "consensus" economic forecast from the July *Blue Chip Economic Indicators* shows real GDP growing at around a 3¼-percent annual rate through the end of 2006 (see table). This moderate rate of growth is roughly consistent with the "potential" or "trend" rate of non-inflationary real growth. As a result, the unemployment rate is expected to remain relatively unchanged in the 5.0-percent to 5.1-percent range in the forecast. Consumer price index [CPI] inflation is projected to moderate, in the 2¼-percent to 2½-percent range. Interest rates are expected to rise gradually through early next year and then stabilize. The forecast shows the U.S. economy in a sustained expansion with low unemployment, inflation and interest rates.

Surging Revenue, Improving Deficit Outlook

The strong performance of the economy is boosting tax revenue and bringing the deficit down. In its most recent *Monthly Budget Review*, the Congressional Budget Office [CBO] reports that Treasury data through June show Federal tax receipts up about 14½ percent this fiscal year compared with the same period last year. In comparison, spending is up about 7½ percent. The report says: "With robust growth in revenues . . . CBO now expects that the 2005 deficit will be significantly less than $350 billion, perhaps below $325 billion." These lower numbers represent a sharp improvement compared to the $400-billion deficit estimate from earlier this year, and also reflect a large decline from last year's final deficit figure of $412 billion.

The improvement in the deficit outlook over the past year and a half is on track to being one of the largest in history – and potentially even the best improvement on record.

Budget Director to Testify

The administration's updated deficit estimates will appear this week when the Office of Management and Budget [OMB] releases its *Mid-Session Review*, with updated budget estimates for the current fiscal year and for fiscal years 2006-10. OMB Director Joshua B. Bolten is scheduled to testify Thursday before the House Budget Committee. (CBO is scheduled to release its mid-year budget update in the middle of August.)

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